Republic of the Philippines
COURT OF TAX APPEALS
Quezon City

SECOND DIVISION

FLUOR DANIEL PHILIPPINES INC.,
Petitioner,

-versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CTA Case No. 7793

Members:
CASTAÑEDA, JR., *Chairperson*
CASANOVA, *and*
MINDARO-GRULLA, *JJ.*

Promulgated:

APR 17 2012
4:25 p.m.

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DECISION

CASANOVA, *J.*:

In this Petition for Review[1], filed on June 10, 2008, petitioner- Fluor Daniel Philippines, Inc., prays for the cancellation and withdrawal of the deficiency final withholding tax assessment for the year 2004, including the surcharges and interest thereon, by the Commissioner of Internal Revenue (CIR), in the total amount of P21,368,659.46.

As culled from the records of the case, the facts are as follows:

Petitioner is a domestic corporation duly organized and existing under and by virtue of the laws of the Republic of the Philippines, with principal office located at Asian Star Building, 2402-2404 Asean Drive, Muntinlupa City.[2]

Respondent is the government official duly charged with the duty of assessing and collecting internal revenue taxes, as well as the power to

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[1] Docket, Vol. I, pp. 4-17.
[2] Par. 1, Joint Stipulation of Facts and Issues (JSFI), Docket (Vol. I), p. 178.

cancel disputed assessments, with office address at the BIR National Office Building, BIR Road, Diliman, Quezon City.[3]

A Formal Letter of Demand dated April 16, 2007 was issued by respondent assessing petitioner the alleged deficiency taxes for 2004 comprising Income Tax, Value-Added Tax (VAT) and Expanded Withholding Tax (EWT).[4]

The assessments, together with interest and compromise, totaling One Hundred Forty-Four Million Five Hundred Thirty-Six Thousand Eight Hundred Sixty-Six Pesos and 21/100 centavos (P144,536,866.21), are broken down as follows:

	Basic Tax	**Interest**	**Compromise**	**Total**
Income Tax	7,562,819.61	3,125,965.44	25,000.00	10,713,785.05
VAT	40,028,389.09	16,344,925.54	25,000.00	56,398,314.63
EWT	53,195,715.83	24,204,050.70	25,000.00	77,424,766.53
Total	**100,786,924.53**	**43,674,941.68**	**75,000.00**	**144,536,866.21**

Included in the EWT assessment was the alleged deficiency EWT on petitioner's payments of maintenance service fees for software maintenance (the "software maintenance service fees") to Fluor International, Inc. (FII), a non-resident foreign corporation. Respondent claimed that, since there was no documentary evidence to show the nature of the contract between petitioner and FII, the software maintenance fees should be treated as income from services and, thus, subject to EWT at 32%.[5]

Thereafter, petitioner filed an administrative protest (Request for Reinvestigation/Reconsideration) on May 18, 2007.[6]

In the said protest, petitioner explained that respondent's assessment for EWT on its software maintenance service fees lacks legal basis considering that they were paid to FII, a resident of the U.S. which is not engaged in trade or business and, has no permanent establishment (PE) in the Philippines. Thus, FII cannot be subjected to tax on the fees received

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[3] Par. 2, JSFI, Ibid, pp. 178-179.
[4] Par. 3, JSFI, Id., p. 179.
[5] Par. 4, JSFI, Id., 179.
[6] Par. 5, JSFI, Id., p. 179.

pursuant to Article 8(1) of the Tax Treaty between the Republic of the Philippines and the United States of America (the RP-US Tax Treaty).[7]

Petitioner, likewise, applied for the abatement of penalties, surcharges and interest[8] on February 27, 2008 pursuant to Section 204(B) of the 1997 Tax Code as implemented through Revenue Regulations No. 15-2007, with respect to the deficiency VAT assessment[9].

In response to petitioner's protest, respondent issued a Final Decision on Disputed Assessment (FDDA) dated March 3, 2008 and the same was received by petitioner on May 9, 2008. In the FDDA, respondent cancelled the income tax and partially cancelled the VAT assessment, but issued an assessment for final withholding tax on petitioner's payments of software maintenance service fees in lieu of the previous EWT assessment appearing in the Formal Letter of Demand dated April 16, 2007. Hence, respondent issued a final deficiency assessment of P21,939,457.85, computed as follows:[10]

Final Withholding Tax (inclusive of increments)	Php21,368,659.46
VAT (inclusive of increments)	P570,798.39
Total	**Php21,939,457.85**

In changing the assessment from deficiency EWT to deficiency final withholding tax (FWT), respondent argued that the software maintenance fees should be considered as "license generating royalty income", citing RMC No. 44-05 as her basis. Thus, she maintained that the software maintenance service fees should have been subjected to the preferred rate of 15% under Article 13 of the RP-US Tax Treaty.[11]

On the basis of the FDDA, which constitutes a denial of petitioner's protest, petitioner filed its Petition for Review before this Court on June 10,

[7] Par. 6, Petition for Review, Id., p. 6.
[8] Annex "E" to Respondent's Answer, Id., p.110.
[9] Par. 7, Petition for Review, Id., p. 6.
[10] Par. 6, JSFI, Id., p. 180.
[11] Par. 7, JSFI, Id., p. 180.

2008, in accordance with the provision of Section 228 of the National Internal Revenue Code of 1997 (NIRC 1997) which provides:

> "SEC. 228. Protesting of Assessment. –
>
> xxx xxx xxx
>
> If the protest is denied in whole or in part, or is not acted upon within one hundred eighty (180) days from submission of documents, the taxpayer adversely affected by the decision or inaction may appeal to the Court of Tax Appeals within thirty (30) days from receipt of the said decision, or from the lapse of one hundred eighty (180)-day period; otherwise, the decision shall become final, executory and demandable."

In her Answer,[12] filed on August 20, 2008, respondent averred the following Special and Affirmative Defenses:

> "8. Petitioner is liable to pay the final withholding tax on the alleged software maintenance service fees being paid to Fluor International Incorporated (FII) for the following reasons:
>
> 8.1. FII failed to comply with the provision of Revenue Memorandum Order No. 01-2000 dated November 25, 1999 entitled "Procedures for Processing Tax Treaty Relief Application". Under said RMO, it is provided that any availment of the tax treaty provisions must be preceded by an application for treaty relief with the International Tax Affairs Division (ITAD) of the Bureau of Internal Revenue.
>
> The implementation of the said RMO is in harmony with the objectives of the contracting states to ensure that the granting of the benefits under the tax treaties are enjoyed by the persons or corporations duly entitled to the same. In this way, the consequences of any erroneous interpretation and/or application of the treaty provisions with which the Philippines is a signatory to (i.e., claim for tax refund/credit for overpayment of taxes, or deficiency tax liabilities for underpayment) can be averted.

[12] Id., pp. 80-105

before proceeding with the transactions and/or paying the tax liability covered by the tax treaty.

It is quite noteworthy to say that the power to interpret the provisions of the Code and other tax laws as provided for under Section 4 of the National Internal Revenue Code shall be under the exclusive and original jurisdiction of the Commissioner of Internal Revenue, subject to review by the Secretary of Finance.

> 'Findings of administrative officials and agencies who have acquired expertise because their jurisdiction is confined to specific matters are generally accorded not only respect but at the time even finality" (*Ibid., citing Motoomull v. Dela Paz, 187 SCRA 743)*. Interpretations by officers of laws which are entrusted to their administration, are entitled to great respect (*Anscor Container Corporation v. Court of Tax Appeals, et al., CA-GR SP No. 38052, August 31, 1998)*

In **Mirant (Philippines) Operations Corporation (formerly: Southern Energy-Asia Pacific Operations [Phils.] Inc. vs. Commissioner of Internal Revenue** *under CTA-E.B. No. 40 (CTA Case No. 6382) promulgated on June 7, 2005,* the Court held that:

> 'A foreign corporation wishing to avail of the benefits of the tax treaty should invoke the provisions of the tax treaty and prove that indeed the provision of the tax treaty applies to it, before the benefits may be extended to such corporation. In other words, a resident or non-resident foreign corporation shall be taxed according to the provision of the National Internal Revenue Code, unless it is shown that the treaty provisions apply to said corporation, and that, in case the same are applicable, the option to avail of the

> tax benefits under the tax treaty has been successfully invoked."

Nowhere in the records of the case was it shown that FII observed the provision of said order. To evince this, a copy of ITAD certification dated July 11, 2008 stating that FII has not secured any tax treaty relief applications before petitioner commenced the filing of the instant petition is hereto attached as 'Annex A' and made an integral part hereof.

Granting for the sake of argument that there are various BIR Rulings as well as ITAD Rulings which might find application to petitioner's circumstances, still, said rulings would not be applicable because not one of the rulings pertain to the foreign corporation such as FII. BIR Rulings are issued based on the facts and circumstances surrounding particular issue/s in question and are resolved on a case-to-case basis. It would be erroneous to invoke the ruling in a specific case which have no bearing to the case of petitioner.

Guided by the foregoing provision, since FII failed to comply with the provisions of RMO 01-2000, it shall be taxed according to the provisions of the National Internal Revenue Code.

8.2 Under Revenue Memorandum Circular (RMC) No. 77-2003 entitled 'Classification of Payments for Software for Income Tax Purposes' dated November 18, 2003, the term 'Royalties' as generally used means:

> 'Payment of any kind received as a consideration for the use of, or the right to the use, any copyright of literary, artistic or scientific work including cinematographic (sic) films or (sic) films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment or for information concerning industrial, commercial or scientific experience. The

> term 'use' as contained herein shall include the reselling or distribution of software.
>
> Software is generally assimilated as a literary, artistic, or scientific work protected by the copyright laws of various countries including the Philippines, thus, payments in consideration for the use of, or the right to use a copyright or a copyrighted article relating to software are generally royalties.

The contract executed between petitioner Fluor Daniel Philippines, Inc. (FDI) and Fluor International Incorporated (FII) states that petitioner is granted free access and usage of the software however petitioner is being charged a monthly maintenance service fee. In addition, the presence of the following terms/conditions appear:

a. A non-exclusive, non transferrable free authority to access or use the software upon request of petitioner;

b. Petitioner shall not make use of the software for time-sharing or otherwise allow its use by third parties without prior written approval of FII;

c. Petitioner is not permitted to make any copies of the software for distribution to third parties;

d. Petitioner is permitted to make and distribute to employees copies of documentation and related materials, but only to the extent that such reproduction and distribution is necessary to petitioner's access or use of the software in accordance with the Agreement;

e. Petitioner shall not decompile, disassemble or reverse-engineer the software or any portion thereof, nor modify or adapt the

> software or documentation, nor create derivative works.

The nature of the contract shows that FII does not transfer all substantial rights to the taxpayer. A transaction does not constitute a sale or exchange because not all substantial rights have been transferred is classified as a <u>license generating royalty income</u> as provided for under Revenue Memorandum Circular (RMC) No. 44-2005 entitled 'Taxation of Payments Software' dated September 1, 2005.

The contract reveals that petitioner is granted authority to use and the right to use the copyright relating to software. The usage and access of the software is limited to the terms and conditions by FII which are stipulated in the contract. Such that, if petitioner fails to comply, it may be subject to cancellation of the contract. FII, therefore, retains full and direct control over petitioner's access and usage of the software. Hence, it loses the character of being 'free' because of the grant of authority is subject to various restrictions.

Consequently, any consideration received by FII for the use of, or the right to use the copyright of the software shall be considered royalties within the definition of RMC 77-2003 and not just a simple 'maintenance service fee' as claimed by petitioner.

The petitioner claims that the 'maintenance service fees' are considered After-sales (sic) Service citing as their basis RMC No. 77-2003. After-sales Service, as embodied in said RMC, is defined as follows:

> 'Contracts for the use of the software are often accompanied with the provision of services (e.g. installation, maintenance and customization of the software) by the personnel of the relevant foreign licensor/owner or of the relevant local subsidiary, reseller and/or distributor. Payments as consideration for after-sales service in a mixed contract are not

> royalties alone, but will include income from services. The appropriate course to take with such contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated payments according to the various parts of what is being provided under the contract, and then to apply to each part of it the proper tax treatment therefor. Thus, the part of the payments representing use of, or the right to use, copyright relating to software will be treated as royalties and taxable as such. The other part of the payments representing the provision of services will be treated as income from services and taxed as such.'

The governing RMC speaks that for the payment/consideration to be qualified as 'after-sales service', there must be a precedent sale of either a License or a System which consists of series of software each containing trade secrets and know-how that are considered proprietary, confidential, and of significant commercial value to FII. In this case, the software is a component and the right to use is given to make the system useful to the end-user.

The contract between petitioner and FII does not show that a license or system was sold to petitioner by FII. Petitioner was only granted free, authority/access or usage of the software necessary in the performance of their activities. Therefore, since there is no prior sale to speak of, then the alleged maintenance service fee cannot be categorized as an 'after sales- service'.

Time and again, where the law speaks in clear and categorical language, there is no room for interpretation, vacillation, or equivocation; there is room only for application.

Furthermore, the contract to be perfected must be accompanied with the provision of services which may be for installation, maintenance and customization of the software. Apparently, the contract does not provide for the scope, specific and exact details relative to the technical support, advice and assistance to be provided by the petitioner on account of the alleged maintenance of services. It also fails to show the manner and method as to how this alleged maintenance services shall be done and the covered period during which said maintenance services is to run. Suffice it to say that the aforementioned matters are necessary to warrant petitioner's payment of said alleged fees.

A careful study under Article 3 of the contract: Compensation and Method of Payment reveals that a term 'maintenance service fee' is to be paid monthly by petitioner for every Home Office and Field Staff per project hour executed in its office. It is clear that the monthly payment was billed for every use, or right to use the software provided by FII.

In addition, it is worth stressing that the alleged maintenance service fee is not to be paid in full but paid on a monthly basis. Neither does it state the specific period during which said payment shall commence and end. If said payments were for the purpose of reimbursement of cost and recovery charges as claimed by petitioner, then the payment should have at least reached a period of finality at a certain point in time. However, no agreement were undertaken to address the issue on the duration of payments to be made by petitioner. Therefore, the obligation of petitioner connotes payment in perpetuity or until such time that petitioner and/or FII exists or the least, unless and until one of the parties revoke the contract.

Likewise, it can be gleaned that no mixed contract was ever created as asserted by petitioner. Such being the case, there is no need to apportion the whole amount of the stipulated payments for royalties on one hand and income from services on the other. In view thereof, since no specific provision for maintenance was entered into by the parties, the monthly maintenance service fee shall be considered as royalties and not an 'after-sales service'. It shall represent payments for the use of, or the right to use copyright relating to software and shall be taxable as such.

With respect to the appropriate taxes for which petitioner should be held liable arising from the payment of royalties, RMC 77-2003 further states that under the section 'Modes of Acquiring Software and the Relevant Tax Treatment Thereof' that, a local end-user may acquire license to use software directly from the foreign licensor/owner of the software. Payments made by the end-user to the licensor/owner as royalties are subject to thirty-two (32%) income tax based on the gross amount thereof as that imposed on royalties derived by a non-resident foreign corporation (Section 28 [B] [1], NIRC), withheld and collected by the subsidiaries, resellers, or distributors making the payments (Section 2.57-1 [I] [1], RR 2-98). However, if the foreign licensor/owner is a resident of a country which has an existing treaty with the Philippines, royalties paid thereto are subject to the reduced tax rates on royalties under the relevant tax treaty, provided the conditions prescribed therein are complied with by the licensor/owner.

The existing Tax Treaty between the United States and the Philippines, Article 13 on Royalties provides:

'2. However, the tax imposed by that other Contracting State shall not exceed –

a. In the case of United States, 15% of the gross amount of royalties, and
b. In the case of the Philippines, the least of:
   1. 25% of the gross amount of royalties
   2. 15% of the gross amount of the royalties, where the royalties are paid by a corporation registered with the Philippine Board of Investments and engaged

in preferred areas of activities; and

3. The lowest rate of the Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third state."

Taking into consideration the preceding section of the Treaty, the rate of 32% is then reduced to 15% of the gross amount of royalties because the royalties are paid by a corporation registered with the Philippine Board of Investments and engaged in preferred areas of activities which is the least applicable rate for the tax deficiency report.

It is quite important to note that Article 3, Note 3 of the contract between petitioner and FII further states that "All taxes payable in the Philippines shall be the responsibility of the taxpayer".

9. Petitioner erroneously asserts that assessment for final withholding tax constitutes a new assessment.

In the Formal Letter of Demand dated April 16, 2007, a 32% Expanded Withholding Tax was assessed against petitioner. At that time, it is submitted that the respondent considered the transaction as an after-sales service wherein the owner or the licensor for the software petitioner is utilizing will receive income from services. Thus, the rate of 32% was applied to said transaction. The oversight was however rectified in the Final Decision on Disputed Assessment (FDDA). This error was occasioned by the fact that during the period the Final Assessment Notice was made, no documentary evidence was presented by petitioner to show the nature of the contract between petitioner and the owner or the licensor of the software. It was only at the time petitioner filed its administrative protest that the contract between the petitioner and FII was produced by petitioner.

Considering the foregoing, respondent was under the duty to charge petitioner the appropriate tax due in the FDDA. Hence, from the Withholding Tax-Expanded category, the tax due from petitioner was reclassified as Final Withholding Tax (Section 28 [B] [1], NIRC in relation to Section 2.57-1 [I] [1], RR 2-98.

The 32% rate applied to royalties derived by petitioner was further reduced to 15% on account of the RP-US Tax Treaty, as petitioner is a resident of the United States. To comply with the mandate of the tax treaty, the rate provided therein was applied.

10. Petitioner in its quest to defeat payment of the assessed alleged deficiency final withholding tax, cited the ruling on CTA EB No. 113 dated September 19, 2006 (CTA Case No. 6656) entitled Commissioner of Internal Revenue vs. Deutsche Bank AG Manila Branch where it was held that petitioner (Bureau of Internal Revenue) cannot change the basis of assessment without complying with the provisions of Section 228 and Section 203 of the NIRC. However, let it be stressed that in the above-mentioned case, petitioner (Bureau of Internal Revenue) for the first time sought alternative relief already in the Memorandum stage of the trial.

Likewise, in **Aguinaldo Industries Corp. Fishing Net Division vs. Commissioner of Internal Revenue et al., (112 SCRA 136)**, which was mentioned in the above-mentioned case, the Court held that

> 'To allow the litigant to assume a different posture when he comes before the court and challenge the position he had accepted at the administrative level, would be to sanction a procedure whereby the court – which is supposed to *review* administrative determinations – would not review but determine and defy for the first time, a question not raised in the administrative forum. This cannot be permitted for the same reason that underlies the requirement of

> prior exhaustion of administrative remedies to give administrative authorities the prior opportunity to decide controversies within its competence, and in much the same way that, on the judicial level, issues not raised in the lower court cannot be raised for the first time on appeal.'

Petitioner is misplaced in citing the previous cases above-mentioned. Said cases are not applicable to the issues at hand, first and foremost, the 'change of assessment' was made after petitioner has filed its administrative protest. To reiterate, the change of category from the Withholding Tax Expanded Category to Final Withholding Tax occurred only during the preparation of the Final Decision on Disputed Assessment (FDDA) because it was only during that time that petitioner produced the contract entered into by petitioner and FII. Had it not been for that relevant document, the amendment would not have occurred. This document, in effect, proved that petitioner is subject to Final Withholding Tax. The respondent has no other option but to charge petitioner the appropriate and correct tax assessment.

The basis of assessment in holding petitioner for the alleged deficiency final withholding tax is RMC No. 77-2003 which is stated in the Final Assessment Notice. It is the very same basis used and applied in the Final Decision on Disputed Assessment. Petitioner was informed in writing of the law and facts on which the assessment is made at the outset. Such being the case, the assessment is valid and no violation of due process was committed.

11. To reiterate, it is clear that petitioner was given the opportunity to challenge the assessment, refute the claim of the respondent, and be heard in the proper forum and during trial by presentation of its pertinent evidence to substantiate its claim. In fact, the change in the assessment was precisely an offshoot of due process accorded to petitioner.

12. The right of respondent to assess, thus, has not yet prescribed. The change of category is not considered as an assessment enough to prevent the respondent from charging petitioner the appropriate taxes. It is not considered a new assessment. Consequently, respondent can still correct the appropriate tax due.

13. With regard to petitioner's VAT deficiency which involves the difference between total amount issued with VAT Official Receipts during the year and income reported as vatable transactions amounting to Php5,686,494.96, the VAT inputed was duly considered, consequently, deficiency was adjusted to reflect the correct taxable basis of Php3,223,193.69. Hence, the total Value Added Tax due inclusive of increments is Php570,798.39. Copy of the computation of said deficiency is attached hereto as Annex 'B' and made an integral hereof.

Out of the VAT deficiency, the petitioner admitted the basic VAT deficiency in the amount of P326,519.37 as evidenced by the deposit made by petitioner of said amount on February 27, 2008 and a letter from petitioner likewise dated February 27, 2008 addressed to the Large Taxpayers Service admitting the above-mentioned circumstance. Copy of said documents are attached as annex 'C' and 'D' and made an integral part hereof. However, petitioner denied payment of legal increments consisting of interest for the period from April 25, 2005 to March 31, 2008, penalty for non-compliance with invoicing requirements and compromise. In relation thereto, it was noted that petitioner filed an Application for Abatement Program under Revenue Regulations No. 15-2007 on February 27, 2008 with regard to corresponding interest and compromise penalties. Said issues are yet to be resolved by respondent on account of the pending Petition for Review filed before this Honorable Court by petitioner. Copy of said Application for Abatement is attached hereto as Annex 'E' and made an integral part hereof.

With regard to the penalty for non-compliance with invoicing requirements, said increment occurred because of petitioner's failure to regularly issue the registered official receipt for each and every zero-rated transaction which gave rise to the above-mentioned VAT deficiency assessment.

> 'Sec. 113. Invoicing and Accounting Requirements for VAT-registered Persons. –
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> a. Invoicing Requirements. – A VAT-registered person shall, for every sale, issue an invoice or receipt. In addition to the information required under Section 237, the following information shall be indicated in the invoice or receipt:
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> 1. A statement that the seller is a VAT-registered person, followed by his taxpayer's identification number (TIN); and
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> 2. The total amount which the purchaser pays or is obligated to pay to the seller with the indication that such amount includes value-added tax.
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> b[13]. Accounting requirements. – Notwithstanding the provisions Section 233, all persons subject to the value-added tax under Sections 106 and 108 shall; In (sic) addition to the regular accounting records required, maintain a subsidiary sales journal and subsidiary purchase journal on which the daily sales and purchases are recorded. The subsidiary journals shall contain such information as may be required by the Secretary of Finance.'

[13] Should be quoted as sub paragraph "C".

Corollary thereto, Section 237 NIRC of 1997 provides:

> 'All persons subject to an internal revenue tax shall, for each sale or transfer of merchandise or of services rendered value at Twenty-five pesos (P25.00) or more, issue duly registered receipts or sales or commercial invoices, prepared at least in duplicate, showing the date of transaction, quantity, unit cost and description of merchandise or nature of service: Provided, however, That in the case of sales, receipts or transfers in the amount of One Hundred Pesos (P100) or more, or regardless of amount, where the sale or transfer is made by a person liable to value-added tax, to another person also liable to value-added tax; or where the receipt is issued to cover payment made as rentals, commissions, compensation or fees, receipts or invoices shall be issued which shall show the name, business style, if any, and address of the purchaser, customer, or client: Provided, further, That where the purchaser is a VAT-registered person, in addition to the information herein required, the invoice or receipt shall further show the Taxpayer Identification Number of the purchaser.
>
> In addition thereto, Section 4.108-1 of RR No. 7-95 requires that the word 'zero-rated' be imprinted on the invoice covering zero-rated sales. It also provides that only VAT-registered persons are required to print their TIN followed by the word 'VAT' in their invoices or receipts, which will be considered as 'VAT Invoice', such that all purchases covered by invoices other than 'VAT Invoice' shall not give rise to any input tax.'

Likewise, Sec. 4.108-1 of Revenue Regulations No. 7-95 entitled Invoicing requirements states that all VAT-registered persons shall, for every sale or lease of goods or properties or services, issue duly registered receipts or sales or commercial invoices which must show:

1. The name, TIN and address of the seller;
2. The date of transaction;
3. The quantity, unit cost and description of merchandise or nature of service; and
4. The name, TIN, business style, if any, and address of the VAT-registered purchaser, customer or client;
5. The word **"zero-rated" imprinted** on the invoice covering zero-rated sales; and
6. The invoice value or consideration.

The requirement of imprinting the word 'zero-rated' is useful, practical and necessary not only with respect to the proper implementation of the provisions of the 1997 NIRC on zero-rated transactions but more importantly, to prevent the granting of refund or tax credit to non-existent input VAT.

In view thereof, the maximum penalty for non-compliance with invoicing requirements under Section 113 and other related sections of the Tax Code will be imposed."

Both parties presented evidence, both testimonial and documentary, to prove their case. On February 22, 2011[14], this Court ordered the parties to file their respective Memorandum within fifteen (15) days from receipt of the said Resolution. In a Resolution dated May 3, 2011, the case was submitted for decision taking into consideration petitioner's Memorandum[15] filed on January 31, 2011 and respondent's Memorandum[16] filed on May 2, 2011.

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[14] Resolution dated February 22, 2011, Docket (Vol. II), pp. 719-720.
[15] Id., pp. 721-787.
[16] Id., pp. 816-855.

From the parties' Joint Stipulation of Facts and Issues,[17] the questions for decision are as follows:

1. Whether or not respondent complied with the due process requirements under Section 228 of the 1997 Tax Code.

2. Whether or not respondent's right to assess petitioner for 2004 has prescribed.

3. Whether or not the change of category of the assessed deficiency tax from Withholding Tax Expanded to Final Withholding Tax in the Final Decision on disputed Assessment is a new assessment.

4. Whether or not petitioner is liable for Final Withholding Taxes for the year 2004.

5. Whether or not the software maintenance service fee paid by petitioner to Fluor Intercontinental Incorporated (FII) is considered royalties within the definition of Revenue Memorandum Circular (RMC) No. 77-2003, as further amended by RMC 44-2005.

6. Whether or not petitioner is required to secure a tax treaty application prior to the filing of the instant Petition before it can avail of the benefits under the RP-US Tax Treaty as laid down under Revenue Memorandum Circular (RMC) No. 01-2000, dated November 25, 1999.

7. Assuming that petitioner is liable for Final Withholding Taxes for the year 2004, whether or not petitioner is liable for the Final Withholding Tax of 32% or at the reduced rate of 15%.

8. Whether or not petitioner is liable to pay legal increments consisting of interest and compromise penalties of non-compliance with VAT invoicing requirements.

9. Whether or not petitioner is liable to pay twenty five (25%) percent surcharge and twenty (20%) percent annual interest for late payment from FDDA dated 3 March 2008 until fully paid pursuant to Sections 248 and 249 of the NIRC.

[17] JSFI, Docket (Vol. I), pp. 181-182.

This Court shall first resolve the third issue as it will determine the other issues raised by both parties.

A careful perusal of the records reveals that in the Formal Letter of Demand[18], respondent, at the onset, classified petitioner's "software maintenance service fees" as an "after-sales service" and subjected the same to EWT at the rate of 32%, pursuant to Revenue Memorandum Circular (RMC) No. 77-03[19], covering the taxable period of 2004.[20]

Not satisfied with the respondent's findings, petitioner then filed an administrative protest (Request for Reinvestigation/Reconsideration) on May 18, 2007, attaching therewith its contract with Fluor International, Inc. as one of its supporting documents.

In response to the said protest, respondent rendered a Final Decision on Disputed Assessment wherein respondent treated the software maintenance service fees as "license generating royalty income" under Section 5 of RMC No. 44-05[21] that should be subjected to a Final Withholding

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[18] Annex "A" to the Petition for Review, Ibid, pp. 18-22.

[19] "**After-sales Service:**
Contracts for the use of software are often accompanied with the provision of services (e.g., installation, maintenance, and customization of the software) by the personnel of the relevant foreign licensor/owner or of the relevant local subsidiary, reseller, and/or distributor. Payments as consideration for after-sales service in a mixed contract are not royalties alone, but will include income from services. The appropriate course to take with such a contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated payments according to the various parts of what is being provided under the contract, and then to apply to each part of it the proper tax treatment therefore. **Thus, the part of the payments representing use of, or the right to use, copyright relating to software will be treated as royalties and taxable as such. The other part of the payments representing the provisions of services will be treated as income from services and taxed as such."** (emphasis supplied)

[20] Last paragraph of Respondent's Memorandum, Docket, Vol. II, p. 844-845.

[21] "*SECTION 5. Characterization of Transactions.* — The character of payments received in a transaction involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program.

a. *Transfers of copyright rights.* — A transfer of software is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described below:

i. The right to make copies of the software for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

Tax and not Expanded Withholding Tax.[22] Accordingly, the tax rate that shall be applied, therefore, is 32% on the income payment remitted to the foreign affiliate. But taking into consideration the tax treaty between the United States and the Philippines, the tax rate that shall be applied is reduced to 15%.

Thus, in the case at bench, petitioner argues that the change in the classification of the assessed deficiency tax from Expanded Withholding Tax in the Formal Letter of Demand to Final Withholding Tax in the Final Decision on Disputed Assessment should be considered as a new assessment.

Respondent, on the other hand, counter-argues that no new assessment was made as it was merely an offshoot of the original assessment.

We agree with petitioner.

The change of assessment from EWT to FWT in the FDDA is considered a new assessment on the following grounds:

First, a careful reading of respondent's FDDA would show that CIR primarily anchors the change of classification of petitioner's deficiency taxes from EWT to FWT on Section 5 of RMC No. 44-05 where she classified the software service maintenance fees as *"license generating royalty income."* However, after reviewing the provisions of the said circular, this Court finds

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ii. The right to prepare derivative computer programs based upon the copyrighted software;

iii. The right to make a public performance of the software;

iv. The right to publicly display the computer program; or

v. Any other rights of the copyright owner, the exercise of which by another without his authority shall constitute infringement of said copyright.

The determination of whether a transfer of a copyright right in a software is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. **A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income.**

When only copyright rights are transferred, payments made in consideration therefor are royalties. On the other hand, when copyright ownership is transferred, payments made in consideration therefor are business income." (emphasis supplied)

[22] Last paragraph of Respondent's Memorandum, Docket, Vol. II, p. 845

that the same is not applicable in the instant case in view of the non-retroactive application of the circulars promulgated by respondent. It is very clear under Section 9 of the RMC No. 44-05 that such circular only covers software payments paid or payable from the date of effectivity of the same, which is September 1, 2005. But, as can be gleaned from the records, the subject of the questioned assessment covers taxable year 2004, thus respondent could not possibly use the provisions of the said circular as her basis in changing her earlier assessment. In a long line of cases,[23] the High Tribunal has consistently ruled that the rulings, circulars, rules and regulations promulgated by the Commissioner of Internal Revenue would have no retroactive application if to so apply them would be prejudicial to the taxpayers.[24]

Second, the concept of *"license generating royalty income"* in RMC No. 44-05, is nowhere to be found in RMC No. 77-03. Hence, the retroactive application by the respondent of RMC No. 44-05 has no leg to stand on.

Third, *We* note that, changing the assessment from EWT to FWT only in the issuance of the FDDA would certainly deprive petitioner of the reasonable opportunity to be heard and submit evidence in support of its defense, which is a clear violation of the due process requirements pursuant to the mandatory provisions of Section 228, to wit:

> "SEC. 228. Protesting of Assessment. — When the Commissioner or his duly authorized representative finds that proper taxes should be assessed, he shall first notify the taxpayer of his findings: Provided, however, That a preassessment notice shall not be required in the following cases:
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> xxx xxx xxx

[23] Among others, Commissioner of Internal Revenue v. Benguet Corporation, G.R. No. 134587, July 8, 2005, 463 SCRA 28, 41; Commissioner of Internal Revenue v. Court of Appeals, et al., G.R. No. 117982, February 6, 1997, 267 SCRA 557, 564; Commissioner of Internal Revenue v. Telefunken Semiconductor Philippines, Inc., G.R. No. 103915, October 23, 1995, 249 SCRA 401.

[24] Intel Technology Phil., Inc., vs. CIR, G.R. No. 166732, April 27, 2007

> The taxpayers shall be informed in writing of the law and the facts on which the assessment is made; otherwise, the assessment shall be void.
>
> Within a period to be prescribed by implementing rules and regulations, the taxpayer shall be required to respond to said notice. If the taxpayer fails to respond, the Commissioner or his duly authorized representative shall issue an assessment based on his findings.
>
> Such assessment may be protested administratively by filing a request for reconsideration or reinvestigation within thirty (30) days from receipt of the assessment in such form and manner as may be prescribed by implementing rules and regulations."

Corollary thereto, the importance of complying with the due process requirements under Section 228 is adequately explained in the case of *Commissioner of Internal Revenue vs. Metro Star Superama, Inc.*, [25] where the High Tribunal had ruled as follows:

> "It is an elementary rule enshrined in the 1987 Constitution that no person shall be deprived of property without due process of law. In balancing the scales between the power of the State to tax and its inherent right to prosecute perceived transgressors of the law on one side, and the constitutional rights of a citizen to due process of law and the equal protection of the laws on the other, the scales must tilt in favor of the individual, for a citizen's right is amply protected by the Bill of Rights under the Constitution. Thus, while 'taxes are the lifeblood of the government,' the power to tax has its limits, in spite of all its plenitude. Hence in Commissioner of Internal Revenue v. Algue, Inc., it was said —
>
> > Taxes are the lifeblood of the government and so should be collected without unnecessary hindrance. On the other hand, such collection should be made in accordance with law as any arbitrariness will negate the very reason for government itself. It is therefore necessary to reconcile the apparently conflicting interests of the authorities and the taxpayers so that the real purpose of taxation, which is the promotion of the common good, may be achieved.

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[25] G.R. No. 185371, December 8, 2010.

xxx xxx xxx

> It is said that taxes are what we pay for civilized society. Without taxes, the government would be paralyzed for the lack of the motive power to activate and operate it. Hence, despite the natural reluctance to surrender part of one's hard-earned income to taxing authorities, every person who is able to must contribute his share in the running of the government. The government for its part is expected to respond in the form of tangible and intangible benefits intended to improve the lives of the people and enhance their moral and material values. This symbiotic relationship is the rationale of taxation and should dispel the erroneous notion that it is an arbitrary method of exaction by those in the seat of power.
>
> **But even as we concede the inevitability and indispensability of taxation, it is a requirement in all democratic regimes that it be exercised reasonably and in accordance with the prescribed procedure. If it is not, then the taxpayer has a right to complain and the courts will then come to his succor. For all the awesome power of the tax collector, he may still be stopped in his tracks if the taxpayer can demonstrate . . . that the law has not been observed."** (Emphasis supplied)

Applying the foregoing law and jurisprudence in the case at bench, records show that the basis of the original assessment in the Formal Letter of Demand was RMC No. 77-03. Consequently, petitioner's defense in its protest letter focused on its non-liability to the said tax. However, in the FDDA issued by respondent, she changed the assessment from EWT to FWT applying this time, the provisions of RMC No. 44-05. Considering that the FDDA constitutes respondent's final decision on the matter, petitioner was therefore, not given the chance to refute within the administrative level the findings of respondent as to the applicability of RMC No. 44-05 to its case, which is a clear violation of Section 228 of the 1997 NIRC, as amended.

After finding that RMC No. 44-2005 is not applicable in the case at bar, This Court holds that, there is no need to further discuss and resolve the second, sixth, seventh and eight issues in the parties' Joint Stipulation of Facts and Issues on the ground that the resolution of the said issues has become moot and academic in view of *Our* stand that the FWT assessment on petitioner's software maintenance services fees is a new assessment.

Lastly, with respect to the ninth issue on whether or not petitioner is liable to pay legal increments consisting of interest and compromise penalties of non-compliance with the VAT invoicing requirements, *We* find that there is no need to delve on the same considering that the only prayer of petitioner in the instant Petition is, for this Court to cancel and withdraw the deficiency final withholding tax assessment for the year 2004, including the surcharges and interest thereon.

WHEREFORE, the Petition for Review is **GRANTED**. The assessments for deficiency Final Withholding Tax on its software maintenance service fees for the year 2004 are hereby **CANCELLED** and **SET ASIDE**.

SO ORDERED.

CAESAR A. CASANOVA
Associate Justice

WE CONCUR:

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
Associate Justice

Cielito N. Mindaro-Grulla
CIELITO N. MINDARO-GRULLA
Associate Justice

ATTESTATION

I attest that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

JUANITO C. CASTAÑEDA, JR.
Associate Justice
Chairperson, Second Division

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, and the Division Chairperson's Attestation, it is hereby certified that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court.

ERNESTO D. ACOSTA
Presiding Justice